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An increasing variety of budgetary positions, with challenging overall developments

Actual deficits continued to increase in 2003 throughout the EU, reflecting the protracted slowdown in growth and the working of automatic stabilisers. In the euro area, the deficit rose from 2.3% of GDP in 2002 to 2.7% of GDP in 2003. If all 25 countries which are members of the EU as of 1 May 2004 are taken into account, the deficit has increased from 2.1% to 2.7% of GDP. Cyclically-adjusted developments have started to evolve more favourably, improving from 2.4% of GDP in 2002 to 2.1% in 2003. However, this reflects sizeable one-off measures in several countries.

With eight countries in surplus and eleven with deficits above 3% in 2003, the EU by enlarging to 25 members sees the variety of budgetary performances across Member States increase. The most significant deficits are those of Germany and France, given the size both of the countries themselves and of their deficits, which heavily affect the overall outcome of the euro area. The situation in Italy, where the deficit stayed below 3% only by dint of sizeable one-off measures, is also a matter of concern given its high government debt-to-GDP ratios. Outside the euro area, actual balances deteriorated in a number of countries, including the UK and Poland. In contrast with these developments, Spain, Belgium, Ireland, Finland and Luxembourg (in the euro area) and Sweden, Denmark, Estonia in the EU-25 recorded surpluses which were maintained throughout the slowdown, attesting to the soundness of their budgetary positions. Reflecting the budgetary and growth developments in large countries, the government debt-to-GDP ratio increased in 2003 to reach 70.4% in the euro area and 63.1% in the EU-25. Here too, situations are quite diverse, with Italy, Greece and Belgium having a government debt-to-GDP ratio above 100% and 14 countries with debt levels well below 60% of GDP.

Sound public finances will not be achieved in the near future in some countries

In spite of an improving growth outlook, budgetary prospects for 2004 and 2005 are not very promising. Both the actual and cyclically-adjusted budget balances of the euro area, according to the Commission Spring 2004 forecasts, are projected to be broadly unchanged in 2004 and, on an unchanged policy basis, in 2005. At EU-25 level, the actual balance is projected to improve marginally to 2.5% of GDP in 2005. The public debt-to-GDP ratio is projected to increase slightly in 2004 to 70.9% of GDP in the euro area and to 63.4% in the EU-25, and to remain at the same level in both areas in 2005. At country level, the deficit is projected by the Commission to remain above 3% of GDP in 2004 in both France and Germany,. The two Member States are committed to bring the deficit below 3% in 2005. The deficit is also expected to be above 3% in 2004 in Greece, the Netherlands, and, if the expiry of one-offs is not compensated by corrective measures, also in Portugal and Italy. The budgetary situation in most new Member States is expected to improve over the next two years.

The latest updates of the stability and convergence programmes show that a close-to-balance position in cyclically-adjusted terms will not be reached in several countries by 2007 (-0.7% of GDP for the euro area). Germany, France, Portugal and the UK in particular will still be far from a balanced budget at that point. This means that there will be an inadequate safety margin to prevent a breach of the 3%-of-GDP reference value in the event of adverse economic conditions. In addition, the medium-term objectives of some euro-area Member States are based on growth assumptions which appear to be overly optimistic. Even if the growth rates expected in the updates were realised, the budgetary targets seem difficult to reach. The new Member States foresee in their convergence programmes an ambitious consolidation of their public finances.

Considering that the implementation record of the programmes has, in several cases, been poor – which has led to a repeated postponement of the achievement of the close-to-balance objective – it is clear that there is no reason for complacency. It is vital for Member States to reach budget positions which ensure that the automatic stabilisers work freely, and decrease the risk of unsustainable public finances in the light of ageing populations, and if the composition of the adjustment is right, would contribute to achieving over the next few years the Lisbon objectives of high growth and employment rates. Past experience shows that significant efforts to improve the underlying budget positions should be undertaken as economic conditions improve: the difficulties experienced in respecting the Treaty requirements in 2002 and 2003 reflect also the fact that countries did not make enough fiscal adjustment during the good times in 1999 and 2000.

Increasing activation of the procedures for budgetary surveillance

By mid-2003, the number of countries placed in an excessive deficit position increased to three, with France joining Portugal and Germany. In spite of the measures taken by France and Germany, it soon became evident that deficits in these two countries, in contrast to Portugal, would remain high in 2003, and that the probability of bringing them below 3% of GDP by the deadline of 2004 was very low in the light of the draft budgets submitted in the autumn 2003. The Commission therefore moved forward with the excessive deficit procedure with the aim of urging France and Germany to take more decisive measures in order to correct their deficits at least by 2005. In spring 2004, following the notification of budgetary data concerning 2003, the Commission started the procedures for Greece, the Netherlands and the United Kingdom, which registered deficits above 3% of GDP in 2003. At the same time, given that the deficit remained below 3% of GDP in 2003, the Commission proposed to repeal the decisions placing Portugal in a position of excessive deficit. On the basis of its forecasts, it recommended that an 'early warning' be addressed to Italy, given the substantial risk of breaching the 3%-of-GDP reference value in 2004. The Commission started the excessive deficit procedure for several new Member States following their accession to the EU. Recommendations will be made to these countries to help pursue a credible multi-annual adjustment path.

Tensions in the implementation of the fiscal framework led to uncertainty

While the procedures foreseen by the Treaty were used smoothly in the run-up to EMU, since the birth of the euro their implementation has become more difficult. In February 2002, the Commission recommended that the Council adopt an 'early warning' addressed to Germany and Portugal. On that occasion, the Council did not follow the Commission's proposals, on account of commitments made by these countries. Similarly, but at a more advanced stage in the procedures, the Council at the end of November of 2003 did not endorse the

Commission's recommendations concerning France and Germany, which extended by one year the deadline for correcting the situation of excessive deficit and implied advancing with the procedures.

The tensions which have arisen in the implementation of the procedures of the Treaty and the SGP, and the diverging interpretation of the latter by the Community institutions, have created uncertainty as to how budgetary surveillance should be conducted. They have also shown that certain elements of the framework should be reconsidered in order to increase both its effectiveness and its credibility.

In response to the difficulties in implementing the fiscal framework, the Commission announced a strategy aimed at seeking legal clarity on the provisions of the Treaty and the SGP, continuing budgetary surveillance, and considering what steps are needed to strengthen economic governance. Accordingly, at the end of January 2004 the Commission asked the European Court of Justice to annul the decisions taken by the Council and the Conclusions adopted at its November meeting. The Court has decided to handle the case in an accelerated procedure.

Meanwhile, in line with its strategy, the Commission continued to conduct budgetary surveillance in accordance with the provisions of the Treaty and the SGP. This involved assessing the 2003 updates of the stability and convergence programmes and preparing draft Opinions for the Council. The Commission also updated the BEPGs including new country-specific budgetary recommendations for 7 countries. It also moved ahead with the procedures for countries not running sound budgetary policies, and also pursued its efforts to improve the quality of surveillance. At the same time, it started to reflect on how the framework could be rejuvenated in order to tackle the shortcomings which have manifested themselves in the first years of EMU.

Analytical improvements made within the framework for EU budgetary surveillance

The Report on *Public Finances in EMU – 2004* highlights four areas where progress has been made in the analysis of budgetary developments, including on (i) the role of one-off measures for the assessment of budgetary positions, (ii) the use of cyclically-adjusted balances for the assessment of the efforts countries have made, (iii) the assessment of the long-term sustainability of public finances, and (iv) the surveillance of contingent liabilities.

The increased focus of multilateral surveillance on more structural factors calls for temporary changes in budgetary positions to be clearly identified, particularly when they are due either to the implementation of budgetary measures with only temporary effects or to the economic cycle.

(i) Among the sources of temporary changes in budgets, 'one-off' measures taken by governments warrant particular attention because they are becoming a frequent and sizeable feature in EU countries. It is therefore important to take account of such measures and the reasons behind them in the surveillance process. This calls for greater transparency of budget measures and a clearer reporting of these measures by Member States, including in the stability and convergence programmes.

(ii) A common methodology which provides figures for the cyclically-adjusted budget balances (CABs) is used at EU level to disentangle changes in the budget which reflect the economic cycle from those which do not, the latter reflecting measures decided by policy-makers. The CABs have proved to be a very useful instrument for assessing the Member

States' budgetary policies. However, the CABs may not reflect discretionary fiscal adjustment efforts entirely correctly. Unexpected changes in potential output can also have an impact on the results. The solution proposed is a simple correction of CABs figures, excluding the small component of the change attributable to unexpected changes in potential growth.

(iii) In 2004, for the third year in a row, the EU budgetary surveillance includes an assessment of the long-term sustainability of public finances on the basis of the updated stability and convergence programmes. This year greater attention has been devoted to increase the qualitative analysis supporting the interpretation of the results obtained, which has significantly contributed to giving the assessment a higher information value. Overall, the analysis shows that risks to long-term sustainability are still present in nine countries. In five of them (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while the others face some risks due either to medium-term budgetary developments (Netherlands and the UK) or to the uncertainties over the long-term projections of pension expenditures (Spain and Portugal). Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society on the basis of current policies.

(iv) To get a comprehensive picture of the sustainability of public finances, liabilities other than those included in the Maastricht definition of gross debt should be considered. Among them are the so-called 'contingent liabilities', which correspond to government obligations that materialise only when particular events occur. The importance of this issue in EU budgetary surveillance has increased over the last years and in particular after enlargement. The stock of contingent liabilities is in fact relatively high in new Member States. Given the various situations and trends in the EU, increasing disclosure and monitoring of contingent liabilities would be a useful step towards strengthening budgetary surveillance in the EU.

Budgetary discipline and increased growth potential are consistent objectives

The EU budgetary rules aim at promoting medium- and long-term budgetary discipline so as to ensure sound budgetary positions. However, the EU framework has been criticised for focusing too much on disciplinary aspects, thereby not being growth-friendly. Against this background, the Report on *Public Finances in EMU - 2004* looks at the questions of how fiscal discipline and the quality of public finances contribute to growth.

The benefits of fiscal discipline

During the tense debate which took place last year about the implementation of the EU framework for fiscal surveillance, many critics stressed that it imposes an excessive focus on fiscal discipline and that this has been detrimental to growth. However, these criticisms are ill-founded. Without the progress towards fiscal discipline accomplished in the past decade thanks to the rules-based framework, the European economy would probably have an even more disappointing growth performance. The Report on *Public Finance in EMU – 2004* shows that, rather than being at the expense of growth, fiscal discipline and sound public finances contribute to a macroeconomic environment that fosters potential growth. A fiscal framework, by preventing protracted fiscal deficits, avoids the negative impact which such deficits have on future income.

The mechanism at work is quite straightforward. When deficits are protracted, a reduction in national savings will follow. In turn, this translates either into a reduction in private investment, or into a worsening of the current account, or both. The extent of private investment crowding-out will depend upon the sensitivity of national savings to interest rates and the degree of international capital mobility, while the behaviour of government investment will mainly depend upon the allocation of total expenditure and the extent to which deficits are used to finance current or capital expenditure. The real issue, then, is not whether a loss of fiscal discipline will translate over the medium term into lower future incomes but by how much and through which channels.

Protracted budget deficits primarily reduce capital accumulation and income prospects, mainly via higher interest rates. The Report on Public Finance in EMU – 2004 shows, in line with empirical evidence, that an additional deficit of one percentage point of GDP in euro-area countries is on average associated with an increase in the spread in the interest rate between long and short-term government bonds of 15-20 basis points. Although small, this increase is likely to have negative effects on investment, which is influenced by long-term interest rates, among other factors.

In addition, the analysis suggests that protracted large budget imbalances in countries with high current account deficits may be a cause of delay in the external adjustment. This concern is of especial importance for new Member States, most of which have in recent years been recording relatively large budget deficits coupled with external imbalances. Though the latter may be explained by catching-up dynamics, keeping budget deficits under control will be essential in order to maintain stable currencies within ERM-II as a necessary step towards joining EMU.

In the debate about the EU fiscal framework, little analysis has been conducted on the quantitative impact that the presence of the framework has exerted on budget balances in EU countries. Simulations with the European Commission QUEST II model indicate that, in the absence of the EU fiscal framework, primary budget deficits for the euro area would have been higher by almost 0.9 GDP points per year over the 1994-2003 period. This suggests that the EU fiscal framework has contributed to avoiding a sizeable build-up of euro-area government debt, which in 2003 would have been about 8 GDP percentage points higher than now. Furthermore, the simulations suggest that higher deficits in the euro area would have initially increased the income level by at most half a percentage point of GDP, but this small effect would have faded away quickly. However, taking into account the impact of debt on risk premia, results indicate that the gains from an absence of fiscal discipline would have been even smaller in the short run and negative in the medium term.

Overall, the analysis suggests that the budgetary adjustment in the 1990s induced by the EU fiscal framework implied a reduction in growth of limited magnitude and duration but laid the foundations for better growth prospects. In the absence of the framework, higher deficits would have crowded out private investment and further reduced potential growth compared with current figures.

Improving the quality of public finances

In view of the importance attached by the Lisbon strategy to the quality of public finances, reflected in the Broad Economic Policy Guidelines (BEPGs) as well as in other process such as the Employment Guidelines and the Open Method of Coordination, the Report on *Public Finances in EMU – 2004* endeavours to clarify the role of the quality of public finances within the EU framework for economic policy co-ordination and investigate possibilities for improving the quality of public finances in practice.

Generally accepted definitions of quality are not available. The Report uses a broad concept, whereby quality of public finances concerns the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities. Regarding the latter, for instance the EU Lisbon strategy identifies sustainable growth, full employment, social cohesion and competitiveness as strategic priorities. A full discussion addressing the quality of public finances with respect to all these aims is beyond the scope of the Report. Therefore, as a starting point for further and more complete analysis and while recognising the partial nature of such exercise, it mainly focuses on the link between fiscal policy and long term growth. Accordingly, the Report starts by reviewing the recent literature on the link between the composition of expenditure and revenue and long-term growth. The findings of existing studies confirm the importance of taking into account both the costs (i.e. higher taxation) and benefits (i.e. reaching policy objectives) of public spending. The major difficulties that empirical studies have encountered concern the distinction between 'productive' and 'unproductive' expenditure. Although there is a certain degree of agreement that a few categories of public expenditure can quite safely be included among 'productive' public expenditures because they are directly aimed at productivity improvements (e.g. R&D, education and infrastructure investment) there is no consensus among researchers concerning the impact of most expenditure items on long-term growth and its timing. This lack of consensus is reflected by the fact that available estimates of 'productive' expenditure in the EU range between 5% and 44% of total public expenditure.

In the light of these difficulties, the analysis of the composition of public expenditure across EU countries focuses on what the changes in the compositions have been and what factors drive these changes. Generally, over the last decade social protection and health care expenditure increased their share in total expenditure, while the latter expressed as a share of GDP has gone down. This suggests that the main drivers of expenditure recomposition over the medium-/long-term are related to underlying upward pressures such as those resulting from ageing and that any framework for the definition of strategic expenditure priorities must take such long-term trends into account.

In recent years, several Member States have introduced medium-term frameworks for expenditure control and reforms to the budgetary process that aim at achieving priorities in the most efficient and effective way by linking public expenditure to policy outcomes (performance budgeting). The analysis shows that, in countries with more effective control of public expenditure, fiscal consolidation in the run-up to EMU has been mainly based on containing expenditure, rather than on raising revenues, thereby contributing to a better long-run growth performance.

Overall, this analysis implies that the allocation of resources and the monitoring of action undertaken to pursue identified priorities should have a greater role in the analysis and conduct of fiscal policy. To this end, the BEPGs should contribute more effectively, as well as other EU processes, to improve the quality of public finances.

Progress should include, first, the exchange of information on how strategic priorities have been fixed with respect to national budgets and what the experiences with implementing them have been. Second, further improvements in data availability are needed – in particular regarding the functional classification of government expenditure – since this is a necessary condition for an appropriate analysis of the contribution of public finances to agreed priorities. Third, a proper design and implementation of medium-term expenditure frameworks and progress in cost-benefit analysis and performance budgeting would help to improve both the control and allocation of existing funds.

Finally, a contribution to the quality of public finances can be given by the Union's Initiative for Growth, through which the European Council has established a roadmap for increased investment at EU scale in physical and human capital to complement structural reform. Serious engagement by the EU institutions and Member States is required in order to ensure that financially and economically viable projects of major relevance are undertaken in a sustained and timely way.

Strengthening the EU framework for economic governance

In 2003, the need for further and more decisive progress in the EU framework for economic governance was highlighted by the difficulties in maintaining budgetary discipline and by the persistently low growth. In spite of important advances made in budgetary surveillance, further efforts are needed to improve the quality of public finances and ensure fiscal discipline. In particular, a number of issues that have arisen with the implementation of the EU framework for economic coordination and fiscal surveillance deserve further attention as dealing with them may strengthen the contribution of public finances to growth and employment.

First, the processes underlying the coordination of economic policies in the EU have proven ineffective at times and the EU coordination framework for economic policy has been perceived as focusing almost exclusively on achieving and maintaining balanced budgets. This may be due to the weak link between the guidelines provided on economic policies and those on fiscal policy (i.e. the links between the BEPGs and the Pact) and to the different levels of stringency of the two processes. This weak link between the two processes makes it more difficult to look at fiscal policy in terms simultaneously of fiscal discipline (budgetary balances) and of the contribution of fiscal policy to growth and employment (composition of the budget). In addition, it often appears that the policy guidelines have a limited influence on national budgets or on the priorities for the EU budget.

Second, the procedural and numerical rules which aim at ensuring fiscal discipline as an instrument for higher growth and stability have shown shortcomings. The framework lacks both incentives for prudent behaviour in good times and rewards for countries with sound underlying budgetary positions. In some cases, the framework has not been stringent enough. As a consequence, some countries have not reduced their debt level as fast as expected at the start of EMU, while others have moved back to deficit levels above those required for adopting the euro. The strict timetable and conditions spelled out by the SGP concerning the excessive deficit procedure have proven to be complex to implement.

These developments showed that both the framework which applies to the conduct of national fiscal policies and the processes underlying the coordination of economic policies in the EU need to be reassessed. Making the EMU macroeconomic framework more effective would contribute to progress towards the objective of higher growth. In this endeavour, the right balance has to be found between the need to keep the economic governance framework stable and predictable and to improve the system on the basis of past experience.

Various parts of the Report on *Public Finances in EMU - 2004* deal with these issues, without being either conclusive or exhaustive.

First, the economic arguments presented above show that, by fostering discipline and quality in public finances, the Treaty – with its numerical and procedural rules – does make an important contribution to growth while allowing room for a proper implementation of the Lisbon strategy.

Second, as the Commission has put forward in its communication on Financial Perspectives, the BEPGs could assume a more prominent role in economic policy coordination by providing better fiscal guidance to Member States, therefore supporting the conduct of national policies and the definition of budgets. One possibility could be to bring the national budgetary policy coordination calendars more into line with the general policy coordination cycle, for example by having an EU six-month period in which policy guidance would be formulated and issued followed by a national six-month period during which Member States would follow up. This would also make it possible to set fiscal policy in the broader context of increasing growth potential and addressing the quality and sustainability of public finances.

Third, in its Communication of November 2002, the Commission already expressed the importance of improving the interpretation of the fiscal rules, in order to take debt developments and country-specific circumstances more into account. The Report on *Public Finances in EMU - 2004* examines several options such as: taking more account of growth developments, in particular of protracted slowdowns, in the implementation of the procedures, including in the application of the deficit criterion and in setting the deadlines for correcting the excessive deficit; and increasing the focus on debt in the surveillance of budgetary developments. The Report also elaborates on the concept, put forward in the Public Finances Report 2001, of reworking the definition of the medium-term objective for fiscal policy, to cater for other (country-specific) circumstances and consider debt levels and the overall sustainability of public finances while ensuring that deficits remain below 3% of GDP in normal circumstances. It reviews other options to improve the functioning of the SGP such as strengthening the incentives to conduct prudent and symmetric-over-the-cycle policies and achieve surpluses in good times, or ensuring early action to correct inadequate developments. The report indicates that improving the knowledge of government budgetary positions – through the analysis of all elements which underlie borrowing requirements and balance sheets and through a reinforcement of the statistical framework – also appears to be important. For the credibility and smooth operation of the fiscal framework, the reliability of fiscal statistics is crucial. To this end, it highlights the importance of strong monitoring of the quality of reported fiscal data and of consistency between the status and prerogatives of national statistical authorities and their task of ensuring the reliability and timeliness of statistics. To this end the Council Conclusions of 2 June 2004 lay down minimum European standards for the institutional set-up of statistical authorities. Full transparency will allow the financial markets to better assess the creditworthiness of the different Member States.

Finally, the Report addresses issues of enforcement at both Community and national level. At Community level, it recalls the advantages of clarifying the authority and the instruments entrusted respectively to the Commission and to the Council. The Commission's role in assessing developments and determining policy recommendations contributes to efficiency. A better articulation and differentiation of roles in the application of the SGP resulting from changes agreed in the European Constitution (such as the capacity of the Commission to issue formal "early warning" directly and to adopt proposals for the Council decisions launching the excessive deficit procedure) is an important first step. The report recalls the merits of the Community's, and in particular the Commission's, power to effectively monitor the application of the fiscal rules by Member States, especially concerning the preventive element of the framework. At national level, it underlines the importance that Member States ensure that institutions are appropriate to the task of ensuring sustainable public finances. This involves both improving budgetary procedures and favouring the dialogue among all actors concerned. In this context the role played in some Member States by national counterparts for the monitoring function fulfilled by the Commission at EU level appears relevant.

The Commission will build on the analysis presented in this Report and proceed with consultations, with the objective to moving towards specific formal proposals for rejuvenating the SGP and strengthening economic governance.